Office Supreme Court, U. S.
F I L E D
APR 13 1955
HAROLD B. WILLEY, Clerk

No. 417

IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

LEWYT CORPORATION (NOW KNOWN AS LEWYT MANUFACTURING CORPORATION), *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

---

REPLY BRIEF FOR PETITIONER

SEYMOUR SHERIFF,
1126 Woodward Bldg.,
Washington 5, D. C.,
Counsel for Petitioner

GARDNER, MORRISON & ROGERS,
Washington, D. C.,
Of Counsel.

INDEX

Page

Introduction 1

Point 1 of Respondent's Brief 2

A. The argument that adoption of taxpayer's position "would cause gross discrimination in favor of taxpayers having fluctuating income as opposed to those with stable earnings" is untenable 2

B. The *Clarion Oil* and *Morgan's Inc.* cases establish that, where necessary to carry out the Congressional purpose, as in this case, the phrase "paid or accrued" may mean either "paid or accrued" 6

C. Subsection (e)(2) of Section 105 of the 1942 Act makes manifest the Congressional purpose to provide meaningful and not illusory relief under Section 122 (b)(6) 7

Point 2 of Respondent's Brief 8

A. The results which the Government objects to will necessarily occur wherever a Section 122 (d) (6) adjustment takes effect under Section 122 (b) (1) 10

B. The amount of the Section 122 (d)(6) adjustment under Section 122 (b)(1) is the excess-profits tax accrued in 1944, that is the tax on income before carry-back 12

C. The Government in substance confesses that the court below erred in applying the "matching principle" upon which its decision was based .. 18

Conclusion 19

Appendix 21

CITATIONS

CASES: Page

Commissioner v. *Clarion Oil Co.*, 148 F. (2d 671 (App. D. C. 1945), *cert. den.*, 325 U. S. 881 (1945) 6, 7
Healy v. *Commissioner*, 345 U. S. 278 (1953) 17
Helvering v. *Morgan's Inc.*, 293 U. S. 121 (1934) 6
Reis, Robert, & Co., 20 T. C. 294 (1953) 5
United States v. *Olympic Radio and Television, Inc.*, 108 F. Supp. 109 (1952), rehearing denied, 110 F. Supp. 600 (Ct. Cl. 1953) 4, 5, 16

STATUTES:

Internal Revenue Code of 1939:

Sec. 23 (26 U.S.C. 1952 ed., Supp. I, Sec. 23) ..14, 17
Sec. 26 (26 U.S.C. 1940 ed., Supp. III, Sec. 26) .. 8
Sec. 43 (26 U.S.C. 1952 ed., Sec. 43) 7
Sec. 48 (26 U.S.C. 1952 ed., Sec. 48) 6, 7, 8
Sec. 102 (26 U.S.C. 1952 ed., Sec. 102) 7, 8
Sec. 122 (26 U.S.C. 1946 ed., Sec. 122) 2-19
Sec. 507 (26 U.S.C. 1952 ed., Sec. 507) 7
Sec. 710 (26 U.S.C. 1952 ed., Sec. 710) 14

Revenue Act of 1939, c. 247, 53 Stat. 862 5
Revenue Act of 1941, c. 412, 55 Stat. 687 14
Revenue Act of 1942, c. 619, 56 Stat. 798 5

Sec. 105 7

Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137

Sec. 304 (e) 6

MISCELLANEOUS:

Mim. 6444, 1949-2 C. B. p. 11 17

IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

No. 417

LEWYT CORPORATION (NOW KNOWN AS LEWYT MANUFACTURING CORPORATION), *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

---

REPLY BRIEF FOR PETITIONER

INTRODUCTION

The Government's brief is devoted primarily to an attempt to establish by the use of elaborate but arbitrary examples that "sweeping and truly astonishing results" will flow from acceptance of petitioner's contentions. (Br. p. 38) We shall show that this is not the case. We shall also show that if, *arguendo*, the Government's examples be accepted as representative, equally "astonishing" results

would flow in parallel examples where a taxpayer is admittedly entitled to benefit from a Section 122 (d)(6) adjustment. In other words, the results which the Government objects to are inherent in Section 122 (d)(6).

What the Government is really arguing therefore is that the Congress made a mistaken policy judgment in enacting Section 122 (d)(6). The appropriate forum for such an argument is the Ways and Means Committee of the House of Representatives and not this Court.

POINT 1 OF RESPONDENT'S BRIEF

A. The Argument That Adoption of Taxpayer's Position "Would Cause Gross Discrimination in Favor of Taxpayers Having Fluctuating Income as Opposed to Those With Stable Earnings" Is Untenable.

The principal argument made by the Government is one urged on, but not adopted by, the Court below—namely, that acceptance of "taxpayer's legal position as to the meaning of 'paid or accrued' * * * would cause gross discrimination in favor of taxpayers having fluctuating income as opposed to those with stable earnings." (Br. p. 18.) This suggestion is untenable for three separate and independent reasons:

1. The examples chosen by the Government are entirely arbitrary, and examples showing exactly the reverse can readily be set forth. If a Section 122 (d)(6) adjustment is made as a result of acceptance of taxpayer's contention, it is just as likely that taxpayers with fluctuating income will still pay greater taxes than taxpayers with stable earnings as it is that the reverse will be true. Thus, the Government's examples all assume that the only adjustment under Section 122 (d) will be the (d)(6) adjustment. This is the only adjustment under subsection (d) which operates to *increase* the amount of a net operating loss, all other adjustments under that subsection acting to *decrease* the amount of a net operating loss. When the amount of such other adjustments under subsection (d)

equals or exceeds the amount of the (d)(6) adjustment, a taxpayer with fluctuating income will invariably pay more taxes than one with stable income even if petitioner's contentions prevail. And, when such other adjustments are not involved, there are still many cases, as illustrated by Example A in the appendix hereto, where a taxpayer with fluctuating income who makes a (d)(6) adjustment in the manner contended for by petitioner will pay more taxes than one with stable income. This is true because a taxpayer who suffers loss years will not obtain in such years the benefit of specific excess-profits exemptions and graduated normal tax and surtax rates available in all years to taxpayers with stable incomes.

2. The very examples selected by the Government—which are patently the most favorable from its standpoint—show on their face that *if the Government prevails* a taxpayer with fluctuating income will pay more tax than one with stable income. Thus Example 3 (Respondent's Brief, Appendix B, p. 23a) shows that, if the Government prevails, the taxpayer in the example with fluctuating income will pay $284,650 in taxes over a four-year period whereas the taxpayer with stable earnings in the same aggregate amount will pay only $205,075. Again, in Example 1 (Respondent's Brief, Appendix B, p. 12a) which, the Government states, sets forth the case of a stable income taxpayer with aggregate income the same as petitioner's, such taxpayer would pay $427,393.32 in taxes. Yet under the decision of the court below, which the Government seeks to justify, the petitioner will be required to pay $567,650.91 in taxes. (Respondent's Brief, p. 14.) Hence, if these examples were representative, they would at best show that acceptance of petitioner's contentions would favor taxpayers with fluctuating income over those with stable earnings whereas acceptance of the Government's contentions would favor taxpayers with stable earnings over those with fluctuating earnings.

The Government offers no reason why this Court should choose the latter alternative over the former. Indeed, as stated by the Government in its brief in *United States* v. *Olympic Radio and Television, Inc.*, No. 10, at p. 27, the Congressional committee reports make it clear that "the underlying purpose in the enactment of the net operating loss deduction was to avoid tax discrimination against businesses with alternating or fluctuating profit and loss years in favor of those with stable profits year in and year out." The Government's own examples show that acceptance of its contentions would perpetuate the discrimination which Congress sought to end. The "discrimination" argument, therefore, is hardly one in favor of the Government. Certainly there is no basis for giving that argument countervailing weight against the fact that the decision below will virtually read Section 122 (d)(6) out of the statute so far as accrual basis taxpayers are concerned. (Petitioner's Main Brief, p. 15 *et seq.*)

3. Even in the limited situations covered by the Government's examples, the results to which it objects are inherent in Section 122 (d)(6) and are not the result of acceptance of petitioner's contentions. The same results would necessarily follow in any comparable case where a taxpayer was entitled to a deduction under Section 122 (d)(6). Thus, in Example 3, the consequences which the Government calls "extravagant" (Br. p. 19), would concededly ensue if the taxpayers in the example were on a cash basis. This would also be true if the accrual basis taxpayer in that example (Taxpayer C) paid in 1946 contested excess-profits taxes for a prior year such as 1942. The Government does not argue that cash basis taxpayers or accrual basis taxpayers who pay contested taxes in loss years should be precluded from taking a Section 122 (d)(6) adjustment because of the "discrimination" which would thereby result in favor of taxpayers with fluctuating income. Its argument that this taxpayer should be precluded from doing so for that reason is therefore plainly untenable.

A similar argument was made by the Government in an abortive effort—since abandoned—to deny Section 122 (d)(6) adjustments even to accrual basis taxpayers who settled contested taxes in loss years. (*Robert Reis & Co.*, 20 T. C. 294 (1953), quoted with approval in the Government's brief in *Olympic Radio*, No. 10, at p. 18.) The reasoning of the Tax Court in making short shrift of that argument is applicable here (20 T. C. at 298):

> "* * * If we accept this argument, it would mean that a cash basis taxpayer in the same situation as the petitioner could not claim the deduction in 1949, though that was the year in which the taxes were paid, for to allow a cash basis taxpayer the deduction in 1949 would distort his excess profits years just as much as in the case of a taxpayer using the accrual system. The respondent does not argue that a cash basis taxpayer could not have the deduction in 1949. We do not accept the argument."

Since the results which the Government objects to in its examples will also occur in *every* comparable case where a Section 122 (d)(6) adjustment is made, it is evident that what the Government is objecting to is the principle adopted by Congress in enacting Section 122 (d)(6). The very enactment of that section gave taxpayers with fluctuating incomes a deduction not given to taxpayers with stable incomes. If that is a "discrimination" in favor of taxpayers who suffer losses over those who do not,[1] it is one conferred by Congress for reasons which Congress found persuasive. The Government argues in effect that

---

[1] As earlier noted, the enactment of the net operating loss provisions in the Revenue Act of 1939 merely removed part of the discrimination *against* taxpayers with fluctuating income. The adjustments in subsections (d)(1) through (d)(5) of Section 122 all operated against taxpayers with losses. Also Section 122 did not compensate taxpayers with fluctuating income for loss of specific exemptions or for the impact of graduated rates on pyramided income. The enactment of Section 122(d)(6) and of the carry-back provisions in the Revenue Act of 1942 in a measure redressed the balance.

Congress made an erroneous policy judgment in giving the Section 122 (d)(6) deduction to taxpayers with loss years. In the Excess Profits Tax Act of 1950,[2] Congress made Section 122 (d)(6) inapplicable with respect to any taxable year ending after June 30, 1950. The Government asks this Court to do what Congress did not do—to make Section 122 (d)(6) inapplicable from the date of its enactment.

B. The Clarion Oil and Morgan's Inc. Cases Establish That, Where Necessary to Carry Out the Congressional Purpose, as in This Case, the Phrase "Paid or Accrued" May Mean Either "Paid or Accrued."

The Government attempts (Br. p. 19) to set forth circumstances which it believes differentiate the *Clarior Oil*[3] line of cases from this case. Such purported distinctions have already been discussed in taxpayer's main brief (pp. 22-28) and that discussion will not be repeated here. But, even if these distinctions be accepted for purposes of argument, they at most establish that *Clarion Oil* does not *require* that the meaning of *either* paid or accrued be applied to Section 122 (d)(6). Be that as it may, it is indisputable that *Clarion Oil* held that, where necessary to effectuate the Congressional purpose, the words "paid or accrued" will be read to mean *either* paid or accrued and not given the meaning set forth in Section 48 (c). In other words, the phrase "paid or accrued" has more than one meaning in the Internal Revenue Code.

The Government's attempted distinction (Br. p. 23) of *Helvering* v. *Morgan's Inc.*, 293 U. S. 121 (1934), on the ground that "paid or accrued" has "only one statutory meaning" is therefore plainly untenable. The rule enunciated in that case (293 U. S. at 128) with respect to statutory predecessors of the sections here involved that "The same

[2] C. 1199, 64 Stat. 1137, Sec. 304(e).

[3] 148 F. (2d) 671 (App. D.C. 1945), *cert. den.*, 325 U. S. 881 (1945).

meaning need not always be attributed to a phrase which, by hypothesis, has more than one meaning for purposes of statutory construction" is thus applicable. Accordingly, "paid or accrued" should be given that meaning which will best carry out the statutory purposes discussed at length in our main brief (pp. 15-19, 29-34). Although recognizing the force of taxpayer's argument as to such purposes, the court below felt precluded from considering them (R. 69) because it was under the erroneous impression that *Clarion Oil* rested on the ground that the chapter of the Code there involved (Chapter 2) contained "no provisions comparable to § 48 (c) and § 43 of Chapter 1 defining the phrase 'paid or accrued.'" (R. 68.) As shown in our main brief (p. 21), the court below overlooked Section 507 (a) of the Code which expressly made Section 48 (c) applicable to Chapter 2. In the face of the unequivocal statement of the court below just quoted, the Government (Br. p. 21) nevertheless urges that the court below "was not oblivious of Section 507 (a)." The Government does not explain why this is so except by quoting two sentences from the court's opinion which do not in any way mention or refer to Section 507 (a).

C. Subsection (e)(2) of Section 105 of the 1942 Act Makes Manifest the Congressional Purpose to Provide Meaningful and Not Illusory Relief Under Section 122(d)(6).

In our main brief (p. 30, *et seq.*), we argue that subsection (e)(2) of Section 105 of the 1942 Act highlights the Congressional purpose to provide a real benefit to taxpayers in a loss year and not an illusory one. The Government restates what this section does and concludes by adding merely that it was aptly included in Section 105 (e) as a technical amendment. Taxpayer's point was that the reasons which impelled the technical amendment to Section 102 of the Code made by subsection (e)(2) of Section 105 of the 1942 Act were equally applicable to Section 122 of the Code. Yet, in the immediately succeeding subsection of the 1942 Act, subsection (e)(3), Congress made a differ-

ent type technical amendment—the addition of (d)(6)—to Section 122. The reason is evident. The (Code) Section 26 (e) credit which was made available in the case of Code Section 102 would have been futile in the case of Code Section 122 since there can be no Section 26 (e) credit (income subject to excess-profits tax) in a loss year. Section 122 (d)(6) was therefore evidently designed to provide meaningful and not illusory relief, an intent which will be thwarted by adoption of the Government's contention. This argument and taxpayer's other arguments based on the legislative history of Section 122 (d)(6) (Main Brief pp. 29-34) remain unanswered.

POINT 2 OF RESPONDENT'S BRIEF

The Government's brief makes no effort to answer taxpayer's discussion of the language of Section 122 (b)(1) and Section 122 (d)(6). Under Point 1 the Government urges that Section 48 (c) permits an accrual basis taxpayer to take into account only taxes accrued within the taxable year. Under Point 2 taxpayer is simply asking that it be permitted to take into account taxes accrued[4] within the taxable year. In view of the inconsistency of its positions, the Government in its discussion of Point 2[5] understandably has little to say about the statutory language. Instead it urges that acceptance of taxpayer's contentions would produce "truly astonishing" results. (Br. p. 38.)

To support this view, the Government places great emphasis on an *over-all* illustration as to the results of

---

[4] If taxpayer prevails on Point 1, it urges that it be permitted to take into account taxes paid within the taxable year. Since, to simplify the discussion, the Government's argument is confined to the "accrued" alternative (Br. p. 33, footnote 22), references to the "paid" alternative will likewise not be repeated in the ensuing portion of this brief.

[5] The Government erroneously states (Br. p. 6) that the Tax Court sustained its position on Point 2. The Tax Court did not pass on Point 2, mistakenly assuming (R. 36) that its decision on Point 1 would dispose of Point 2.

acceptance of taxpayer's contention on *both* Question 1 and Question 2. (Br. pp. 13-15, 17, 25-31.) In making this argument, the Government is really asking this Court not to let taxpayer prevail on both questions but only on one of them. This is the only possible relevance of the over-all illustration for, as the Government in effect admits (Br. p. 17), it could have no logical bearing on *either* Question 1 or Question 2, considered separately, since the illustration does not, of course, isolate the effect of a decision as to either question. We therefore need pause only briefly to examine the over-all illustration. Thus, it should be noted that the same results portrayed would occur on comparable facts where Section 122 (d)(6) admittedly applies (as in the case of cash basis taxpayers or where contested taxes are involved). This being true, the results which the Government objects to are inherent in Section 122 (d)(6). Far from being astonishing, they are results which inevitably occur in many situations under the annual accounting system rather than results occasioned by accepting the contentions made by taxpayer in this case.

Since the Government's over-all illustration has no pertinence to Point 2, taken by itself, the ensuing discussion will be confined to the Government's argument dealing with Point 2 "standing alone." (Respondent's Brief pp. 6, 32-39.) In view of the emphasis given by the Government to the over-all illustration, it is first necessary to set in perspective the income which will be subject to tax if the taxpayer prevails on the second issue only. In that event, taxable income for 1944 will be, as held below, $420,540.43. (R. 4.) The taxable income found by the court below for 1945—$338,818.29[6]—will be reduced by $164,326.38 to $174,491.91.

---

[6] The Commissioner found 1945 net income to be $282,865.25. (R. 11.) The Tax Court denied an interest deduction of $55,949.04 allowed by the Commissioner (R. 28-29, 36), thereby increasing taxpayer's 1945 net income to $338,818.29, the figure set forth in the text. See Respondent's Brief, p. 4, footnote 3.

A. The Results Which the Government Objects to Will Necessarily Occur Wherever a Section 122(d)(6) Adjustment Takes Effect Under Section 122(b)(1).

The Government summarizes its argument under Point 2 as follows (Br. p. 6):

> "Taxpayer's theory as to Question 2, standing alone, leads to the conclusion, no less extraordinary, that a 1946 net operating loss may be applied as an offset to net income earned in the second preceding year (1944) and still be available, undiminished in amount, for application against the income of the first preceding year (1945)."

Stated otherwise, the Government objects to the "double benefit" (Br. p. 34) which it claims would result from acceptance of taxpayer's contention.

The argument that adoption of taxpayer's position would cause a "double benefit"[7] simply reflects the Government's consistent refusal to recognize that, under the specific terms of Section 122 (b), Congress has provided that a Section 122 (d)(6) adjustment is to be made. The logic of the Government's "double benefit" contention would effectively preclude *any* taxpayer from ever obtaining *any* benefit whatsoever from the (d)(6) adjustment under Section 122 (b)(1). That this is the necessary result of the Government's position cannot be obscured by semantics such as the "double benefit" argument.

The Government concedes (Br. p. 38) that the meaning which it urges should be attributed to the word "imposed" (see Point 2B, p. 12, *infra*) would result in the ordinary accrual basis taxpayer never receiving any benefit from the Section 122 (d)(6) adjustment under Section 122 (b)(1),

---

[7] Even if the Government's theory as to what constitutes a "double benefit" be accepted, *arguendo*, the "double benefit" would not occur in cases where the adjustments under Sections 122 (d)(1) through 122 (d)(5) offset the (d)(6) adjustment. Yet the principle which the Government seeks to establish here would deny a (d)(6) adjustment in such cases even though what the Government calls a "double benefit" could not conceivably occur.

a point demonstrated mathematically in Petitioner's Main Brief at p. 49 *et seq.* It states, however, that a "limited" application would remain for these two sections in the case of cash basis taxpayers and of accrual basis taxpayers who contest taxes or have abnormalities in income. If the Government's "double benefit" theory be accepted, Section 122 (d)(6) and Section 122 (b)(1) would not have even this limited application. As shown below, under that theory those sections would never apply.

What the Government is really arguing, therefore, is not that Section 122 (d)(6) and Section 122 (b)(1) should be construed to avoid a "double benefit" but that they should be construed so as to prevent the allowance of any benefit under any circumstances. In effect, the Government urges that, although Congress deliberately made the (d)(6) adjustment applicable to (b)(1), it is "inconceivable" (Br. p. 33) that Congress intended any benefit ever to arise from such adjustment.

This may be readily illustrated. Let us assume that an accrual basis taxpayer had a net operating loss of $500,000 in 1946 and a net income before carry-back of $500,000 in 1944, that $100,000 of excess-profits taxes accrued with respect to such $500,000 net income in 1944, and that there were no other adjustments under subsection (d) of Section 122 in 1944. Under taxpayer's contention, $500,000 would be carried back to 1944. The carry-back to 1945 would be $100,000 since the (d)(6) adjustment under (b)(1) would reduce the 1944 net income from $500,000 to $400,000, leaving an excess of $100,000 of the 1946 net operating loss ($500,000) over "adjusted" 1944 net income ($400,000). The Government argues that allowance of the (d)(6) adjustment of $100,000 would result in permitting a deduction of $100,000 of the 1946 loss in 1945 although the entire 1946 loss had already been deducted in 1944. But this is the very purpose of the (d)(6) adjustment under (b)(1) to net income of the second preceding year. Let us change the illustration so that either (a) the taxpayer is on a cash basis and $100,000 of excess-profits taxes were paid

in 1944 with respect to 1943 taxes, or (b) the taxpayer is on an accrual basis but the excess-profits tax accrual of $100,000 in 1944 resulted from settlement of 1942 taxes in 1944. In both of such cases, the taxpayers admittedly will be permitted to make a (d)(6) adjustment to 1944 income of $100,000 and hence to take a deduction of $100,000 of the 1946 loss in 1945 although the entire 1946 loss has already been deducted in 1944. Yet if the Government's "double benefit" theory were applied, this would not be permitted and no taxpayer could ever obtain the benefit of the (d)(6) adjustment under (b)(1). The Government does not argue that the (d)(6) adjustment may not be applied to (b)(1) in these situations although on its theory a "double benefit" would result therefrom. Its argument that this taxpayer should not be permitted to make this adjustment by reason of the same "double benefit" that would result therefore falls of its own weight.

What the Government calls "double benefit" could be eliminated from Section 122 only if the amount of net operating loss which could be carried back to the first preceding year were defined as the excess of the loss over the net income (before carry-back) of the second preceding year. Congress did not so provide. Instead it defined the carry-back to the first preceding year as the excess of the loss over the net income (before carry-back) of the second preceding year *reduced by the Section 122 (d)(6) adjustment.* The Government would read the italicized language out of the statute. In essence, the Government contends that Congress exercised mistaken judgment in making Section 122 (d)(6) applicable under Section 122 (b)(1). This is the wrong forum for such an argument.

B. The Amount of the Section 122(d)(6) Adjustment Under Section 122(b)(1) Is the Excess-Profits Tax Accrued in 1944, That Is, the Tax on Income Before Carry-Back.

It is a fundamental principle of tax law that the tax accrued within a year is the tax computed on the basis of the facts existing at the end of such year. Subsequent

events, such as a carry-back from a later year, cannot affect the amount of the original accrual. (Petitioner's Main Brief, p. 38 *et seq.*) Although not questioning this principle, the court below held the tax "accrued" within the year 1944 to be the tax finally determined on the ground that such meaning was necessary to carry out what it deemed to be the statutory pattern (R. 71-72), a ground of decision discussed in detail in Petitioner's Main Brief at pp. 34-37. The Government does not attempt to argue in this Court that the tax "*accrued*" in 1944 was the tax as finally determined in later years. Instead it attempts to sustain the judgment below on other grounds.

The only justification the Government finds in the language of Section 122 (d)(6) for upholding the decision below that the Section 122 (d)(6) adjustment is for the tax finally determined to be due is the use of the word "imposed" in that section. It will be recalled that Section 122 (d)(6) permits a deduction for the "tax *imposed* by Subchapter E of Chapter 2 [Excess-Profits Tax] paid or accrued within the taxable year." In our main brief (pp. 40-49) we have shown in detail that the word "imposed" in Section 122 (d)(6) does not have the meaning the Government seeks to attribute to it. Being unable to controvert this argument, the Government simply repeats its dogma that (Br. p. 34) "There were not two excess-profits taxes imposed for 1944, but only one, and that one was the amount as finally determined * * *." Even if true, this would be irrelevant since, as pointed out in our main brief (p. 40 *et seq.*), the word "imposed" is *not* used in Section 122 (d)(6) by way of limitation of the amount of the deduction. It is there used simply by way of identification of a tax which could not suitably be described by popular name, there also having been a declared value excess-profits tax in effect when Section 122 (d)(6) was enacted. This very understanding is specifically set forth in the pertinent committee reports which described the Section 122 (d)(6) adjustment as allowing a deduction for "the excess-profits tax paid or accrued within taxable years." (Petitioner's

Main Brief, p. 42.) The word "imposed" was not used, since the context made it apparent which excess-profits tax was referred to.

In any case, the Government's unsupported statement that the only excess-profits tax imposed for 1944 was the tax finally determined is demonstrably incorrect, as shown in our main brief (p. 45 *et seq.*). For example, the very section of law (Section 710 of the Code)—entitled "*Imposition of Tax*"—levying the excess-profits tax provides that the tax "imposed" is the tax "levied, collected, and paid." The tax levied, collected, and paid in this case is, of course, the tax initially determined (before carry-back) by the taxpayer on its return, not the tax finally determined by the Commissioner. Other illustrations of this same usage are set forth in our main brief. And even if the meaning of the word "imposed" were equivocal in that respect, the tax imposed *accrued within the taxable year* can only be the tax initially imposed, not that determined in a *later taxable year*.

The Government ignores all this. It merely says that "It seems inconceivable that Congress proposed that this adjustment should be made without regard to the known and established facts relating to the liability for the earlier period" (1944). (Br. p. 33.) Far from being inconceivable, that is exactly what Congress did in Section 122 (b)(1). It provided in terms under Section 122 (b)(1)(B) that the *net income* for the second preceding taxable year (1944 in this case) shall be computed without regard to the net operating loss for the taxable year (1946). In other words, in making the computation under Section 122 (b)(1), the subsequently established fact of a net operating loss is specifically excluded from consideration.

Indeed, the legislative history of Section 122 (d)(6) shows that what the Government regards as "inconceivable" was specifically and deliberately provided for by Congress. As noted in our main brief (p. 31), Section 122 (d)(6) was copied virtually verbatim from Section 23 (c)(2) of the Code, as amended by the Revenue Act of

1941. (Main Brief, Appendix A, pp. 63-64.) That section provided for a deduction for taxes paid or accrued within the taxable year subject to four limiting rules—Rules (A), (B), (C) and (D)—for that deduction "in the case of the excess-profits tax imposed by Subchapter E of Chapter 2." Rules (B), (C) and (D) were incorporated word for word as Rules (A), (B) and (C) of Section 122 (d)(6). Old Rule (A) was omitted from Section 122 (d)(6). That rule provided that

> "in the case of *the excess-profits tax imposed by Subchapter E of Chapter 2*—
>
> "(A) The deduction shall be limited to the *tax imposed* for the taxable year * * *." (Italics supplied.)

Congress incorporated practically verbatim in Section 122 (d)(6) the italicized identifying language preceding Rule (A) but deliberately omitted that rule from Section 122 (d)(6). Old Rule (A) would have limited the (d)(6) adjustment to the "tax imposed." The Government asks that this Court write old Rule (A) into Section 122 (d)(6) despite the fact that the Congress deliberately refused to do so.

Finally, the Government urges that "the plain purpose of the net operating loss provisions is to effect an exception to the annual period for tax accounting and to substitute a five-year unit", that is the loss year plus the two preceding and two following years. (Br. p. 37 and footnote 26.) This statement will not stand analysis. Of course, Congress permitted carry-forward and carry-back of losses, but it specifically provided for the measurement of such losses by reference to the annual accounting period. In particular, Section 122 (d)(6) provides for a deduction for the tax "paid or accrued *within the taxable year.*" The very use of the phrase "accrued within the taxable year" in the section in controversy necessarily embodies the annual accounting principle; if events after the taxable year are taken into account, the word "accrued" is read out of the statute. Indeed, a deviation from the annual accounting

principle here would, as the Government admits (Br. p. 38), make the Section 122 (d)(6) adjustment under Section 122 (b)(1) futile for all practical purposes so far as accrual basis taxpayers are concerned. (Petitioner's Main Brief, p. 49 *et seq.*)

Paradoxically enough, the foundation of the Government's argument on Point 1 depends on the annual accounting principle. Thus, it attempts in Point 1 to demonstrate that accrual basis taxpayers will occasionally have a (d)(6) adjustment under Section 122 (a) by citing the case of a contested tax liability settled and hence accrued in a loss year. (*Olympic Radio* Brief, No. 10, p. 18.) For example, a contested 1944 tax liability settled in 1946 (a loss year) could be accrued in 1946 and added to a taxpayer's 1946 net operating loss. But if the annual accounting principle does not apply under Section 122, such tax should be treated as a 1944 item, rather than, as the Government contends under Point 1, a 1946 item. Having adopted the annual accounting principle as a basic premise of its argument under Point 1, the Government is hardly in a position to disclaim its application under Point 2.

The Government seems to deem it significant (Br. pp. 35-36) that the tax accrued by taxpayer for 1944 was subsequently refunded to taxpayer in part as a result of reduction of its income through renegotiation in a later year.[8]

---

[8] The Government states (Br. p. 34) that the tax finally determined for 1944 was the amount determined after some thirteen "corrections." The great dollar bulk of the "corrections" involve events such as renegotiation and a net operating loss deduction *arising out of events occurring in later years.* The other "correcrections" involve the usual adjustments arising on audit of a return. Acceptance of the Government's implication that these latter corrections—which the Government terms "errors"—should be taken into account in determining the tax accrued in 1944, could only be favorable to taxpayer since the tax accrued for that year will thereby be increased over the $625,561.59 figure claimed by the taxpayer. This is true because the balance of such "errors" resulted in increasing the taxpayer's income over that reported on the return. (R. 4.) The point is actually academic on the facts here involved since any increase in taxpayer's accrued income for 1944 over $584,866.81 will not affect the ultimate result.

But the Government makes no mention of the established rule under the annual accounting system (Petitioner's Brief, p. 38, footnote 33) that the tax accrued in a taxable year is the tax on the income of that year before adjustment for renegotiation occurring in a later year. The basis of this and other holdings under the annual accounting rule has been aptly set forth by the Commissioner (Mim. 6444, C. B. 1949-2, p. 11, at 12):

> "Since the decision in *Burnet* v. *Sanford & Brooks Co.* (282 U. S. 359 * * * (1931)), emphasis has been given to the point that income taxation is on an annual basis. So long as an item of income or expense was properly accounted for in one period, no change is justified under this doctrine merely because events in a subsequent period might materially change the treatment of the original item. The opinion of the Supreme Court of the United States in *Security Flour Mills Co.* v. *Commissioner* (321 U. S. 281 * * * (1944)), reiterated this doctrine."[9]

Acceptance of the Government's argument that use of the word "imposed" in Section 122 (d)(6) provides a basis for abandonment of the annual accounting system would have far-reaching and startling implications. As earlier noted, a cardinal principle under the annual accounting system is that a deduction for taxes accrued under Section 23 (c) of the Code is taken upon the basis of the facts existing at the end of the taxable year even though the tax may subsequently be refunded. (Petitioner's Main Brief, p. 38 *et seq.*) The Commissioner's implementing regulations under Section 23 (c) use the word "imposed" in exactly the same sense as in Section 122 (d)(6), stating that taxes *imposed* by specified laws are deductible when paid or accrued. (Petitioner's Main Brief, p. 43.) Acceptance of the Government's argument as to the meaning of the word "imposed" would therefore

---

[9] The annual accounting principle has recently been applied by this Court in *Healy* v *Commissioner*, 345 U. S. 278 (1953).

overturn the established rule that taxes may be deducted in the year accrued despite the fact they are subsequently refunded. The effect of the Government's argument is that this settled rule should be reversed.

C. The Government in Substance Confesses That the Court Below Erred in Applying the "Matching Principle" Upon Which Its Decision Was Based.

The Government urges that "taxpayer's theory suffers * * * from a glaring internal inconsistency." (Br. pp. 34-36.) This is said to arise because taxpayer under Section 122 (b)(1) reduces the finally determined 1944 net income—stated by the Government to be $584,866.81 (Br. 35)—by the tax originally accrued for 1944—$625,561.59. The Government states that the tax accrued figure must be deducted from the figure "*on the basis of which the * * * tax was computed.*" This is the "matching" principle which the court below relied on. As shown in detail in our main brief (pp. 34-37), the "matching" principle is nowhere expressed by Congress and is specifically negatived by the conceded meaning of Section 122 (b)(1) in other situations. The Government does not meet this point in any way.

But if it be assumed, *arguendo,* that the guiding principle under Section 122 (b)(1) is that the Section 122 (d)(6) adjustment must be deducted from (matched against) the figure "*on the basis of which the * * * tax was computed*", then the Government has confessed that the decision of the court below was in error. The court below held (R. 72) the Section 122 (d)(6) adjustment to be $280,540.33—the tax finally determined for 1944 on income *after* carry-back—and subtracted this adjustment from $584,866.81, the 1944 income *before* carry-back. The tax of $280,540.33 was not computed upon the basis of the figure from which it was subtracted by the court below. It was computed on the basis of the 1944 income after carry-back—$420,540.43. (R. 4, 9; Petitioner's Main Brief p. 36; Respondent's Brief

p. 35, footnote 24.) It is therefore evident that the Section 122 (d)(6) adjustment to 1944 net income *before* carry-back ($584,866.81) found by the court below—namely, the tax ($280,540.33) on income *after* carry-back—is incorrect even on the matching theory adopted by the court below and urged here by the Government.

In falling into this error, the court was doubtless influenced by an erroneous statement inadvertently made by the Government in its brief below. In that brief (p. 41), the Government claimed that taxpayer was inconsistently contending that the tax accrued figure for 1944 ($625,561.59) should be subtracted "from the much lesser *net income ($584,866.81) upon which the 1944 excess-profits tax of $280,540.33, as finally imposed, was computed.*" Although the Government now recognizes in a footnote (p. 35, footnote 24) that the tax figure of $280,540.33 was actually computed upon 1944 net income of *$420,540.43*, it quotes with approval (p. 35) language of the Court of Appeals embodying this error. Thus it cites (p. 35) the erroneous reference by the Court of Appeals to the "1944 income as finally determined ($584,866.81)." Indeed, the Government repeats in the text of its brief in this Court (pp. 34-35) the same error that the corrected (finally determined) net income for 1944 was $584,866.81.

CONCLUSION

Taxpayer respectfully submits (Question 1) that the proper amount of the Section 122 (d)(6) adjustment under Section 122 (a) is the tax "paid" within the taxable year, and (Question 2) that the proper amount of the Section 122 (d)(6) adjustment under Section 122 (b) is either (a) if taxpayer prevails on Question 1, the tax "paid" within the taxable year, or (b) if the Government prevails on Question 1, the tax "accrued" or determined on the basis of facts existing at the end of the taxable year and not the tax ultimately determined after taking into account events arising in later years.

For the foregoing reasons, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

SEYMOUR SHERIFF,
1126 Woodward Bldg.,
Washington 5, D. C.,
Counsel for Petitioner

GARDNER, MORRISON & ROGERS,
Washington, D. C.,
Of Counsel.

April, 1955.

APPENDIX

EXAMPLE A (See p. 3)

This example involves the calendar years 1944 through 1947, the same years selected in the Government's Example 3 (Brief, Appendix B, p. 23a). There was no excess-profits tax in 1946 and 1947. X Corporation and Y Corporation are on the accrual basis and each has an aggregate income over the four-year period of $80,000. Assume each has an excess-profits credit for each year of $10,000.

TAXPAYER X CORPORATION

Year	Net Income	Total Tax Applying Petitioner's Contention as to Section 122(d)(6)
1944	$24,000	0
1945	(20,580)	0
1946	25,580	$ 6,057.60
1947	51,000	19,380.00
Aggregate	$80,000	$25,437.60

TAXPAYER Y CORPORATION

Year	Net Income	Total Tax
1944	$20,000	$ 5,300.00
1945	20,000	5,300.00
1946	20,000	4,500.00
1947	20,000	4,500.00
Aggregate	$80,000	$19,600.00

Computations Applicable to X Corporation

SCHEDULE 1

Computation of Income and Excess-Profits Tax for 1944 for X Corporation Applying Petitioner's Contention

1. Net income (prior to Sec. 26 (e) credit and carry-back of 1945 net operating loss)		$24,000.00
2. Less: 1945 net operating loss before 122 (d) (6) adjustment	$20,580.00	
1944 excess-profits tax paid in 1945—(d)(6) adjustment (Item 17 below)	3,420.00	
1945 net operating loss		24,000.00
3. Normal tax and surtax net income		0
4. Income tax		0
5. Excess-profits tax		0

Computation of 1944 Excess-Profits Tax Paid in 1945
(Before Carry-Back of 1945 Net Operating Loss)

6. Excess-profits net income (Item 1 above)		$24,000.00
7. Less:		
Specific exemption	$10,000.00	
Excess-profits credit	10,000.00	20,000.00
8. Adjusted excess-profits net income		4,000.00
9. 95% of $4,000.00		3,800.00
10. Computation of the 80% limitation:—		
11. Surtax net income prior to Sec. 26 (e) credit and carry-back from 1945 (Item 1 above)		$24,000.00
12. 80% of $24,000.00		$19,200.00
13. Less: Chapter 1 income tax		5,300.00
14. Limitation of excess-profits tax		$13,900.00
15. Excess-profits tax for 1944 (lesser of Item 9 and Item 14)		$ 3,800.00
16. Less: Postwar credit		380.00
17. Net excess-profits tax on income before carry-back		$ 3,420.00

SCHEDULE 2

(No Tax for 1945 for X Corporation—Loss Year)

SCHEDULE 3

Computation of Income Tax for 1946 for X Corporation

1. Normal tax net income	$25,580.00
2. Normal tax on first $25,000.00	$ 4,250.00
3. Normal tax on $580.00 @ 31%	179.80
4. Surtax on $25,000.00 @ 6%	1,500.00
5. Surtax on $580.00 @ 22%	127.60
6. Income tax	$ 6,057.40

SCHEDULE 4

Computation of Income Tax for 1947 for X Corporation

1. Normal tax net income	$51,000.00
2. Normal tax @ 24%	$12,240.00
3. Surtax at 14%	7,140.00
4. Income tax	$19,380.00

Computations Applicable to Y Corporation

SCHEDULE A

Computation of Income Tax for 1944 for Y Corporation
(Same Computation for 1945)

1. Normal tax net income	$20,000.00
2. Normal tax on first $5,000.00 @ 15%	$ 750.00
3. Normal tax on next $15,000.00 @ 17%	2,550.00
4. Surtax @ 10%	2,000.00
5. Income tax	$ 5,300.00
6. Excess-profits tax (excess-profits net income of $20,000.00 (Item 1) wiped out by specific exemption of $10,000.00 and excess-profits credit of $10,000.00)	0

SCHEDULE B

Computation of Income Tax for 1946 for Y Corporation
(Same computation for 1947)

1. Normal tax net income	$20,000.00
2. Normal tax on first $5,000.00 @ 15%	$ 750.00
3. Normal tax on next $15,000.00 @ 17%	2,550.00
4. Surtax @ 6%	1,200.00
5. Income tax	$ 4,500.00